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April 21, 2008

AGENDA ITEM 5

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Inflation-Linked Asset Class Policy – Adoption of Infrastructure Program Component (FIRST READING)

II. PROGRAM: Inflation-Linked Asset Class Policy

III. RECOMMENDATION: To approve the first reading of the Infrastructure Program Component of the Inflation-Linked Asset Class Policy

IV. ANALYSIS:

Background

In December 2007 the Investment Committee (Committee) approved a 5% target allocation to the new Inflation-Linked Asset Class (ILAC) consisting of commodities, inflation-linked bonds, forestland and infrastructure. Also in December 2007, the Investment Policy Subcommittee approved, subject to revisions, investment policies for the overall inflation-linked asset class for three of the four ILAC components: the commodities program, inflation-linked bond program, and forestland program. These policies were adopted by the Committee in February 2008.

Staff recommends that the Policy Subcommittee approve the proposed ILAC Infrastructure Program Component (Attachment 1). For the Subcommittee's reference, Staff has also provided the overarching Inflation-Linked Asset Class Policy which was adopted by the Committee in February 2008 (Attachment 2). In addition to other contingencies, Investment Committee approval of the infrastructure policy is a precondition to investing in new infrastructure opportunities.

CalPERS has previously invested in three infrastructure funds through the Real Estate and AIM programs. These investments were consolidated into the infrastructure investment accounts under the ILAC as approved by the Committee effective October 1, 2007.

Infrastructure assets are the physical structures, facilities, and networks which provide essential services within a community such as transportation assets, energy and utility services, water and communications systems, as well as public facilities such as schools, hospitals, and government buildings. These assets and businesses provide primary services which are crucial to the success of economic development in society. When these assets are inadequate or perform at a less than optimal level, they severely hamper a community's productivity and growth.

The ownership and operation of infrastructure assets can be public or private. In the case of infrastructure services provided by the private sector such as electricity, gas, water, public transportation, they are heavily regulated by government due to their monopolistic or essential nature. Recently, many countries including the U.S. have seen a trend toward private sector participation in the form of ownership and operation of public infrastructure due to the enormous need for capital, strained government budgets as well as the need to provide efficient and quality services to the public. These Public Private Partnerships (PPPs) take many forms, with varying degrees of private sector control and involvement. Many countries such as United Kingdom, Australia, Canada, and many emerging market countries have developed successful PPP models and the scale of investments in such projects has increased dramatically. In the U.S. PPPs are relatively new. However, the need for infrastructure investment is great and it may not be feasible for this to be accomplished without significant private sector involvement. With the formation of the ILAC, CalPERS is well positioned to invest in infrastructure as CalPERS will pursue both private and public sector opportunities, and the opportunities in both sectors are very sizable.

Infrastructure investments are meant to provide diversification to the CalPERS investment portfolio. They have different risk/return characteristics to both real estate and private equity and some similarities in the way investments are sourced, structured and managed. Infrastructure assets have long term inflation-linked predictable cash flows on the basis of long concessions or off-take agreements .Expected returns for mature infrastructure is above core real estate. Expected returns for development (greenfield) oriented infrastructure is higher and closer to opportunistic real estate but generally less than private equity. The acquisition and management of infrastructure assets is more complex and intensive than real estate and hence fees are likely to be higher than real estate but marginally less than private equity for the overall program. The infrastructure program aims to exceed the benchmark of CPI plus 5%. The 5% real return benchmark is an aggressive target compared to the implicit expected real returns (geometric) of 5.8% for U.S equity, 4.6% for real estate and 2.8% for fixed income assumed in the recent asset allocation analysis. The real return target for infrastructure is comparable to the total fund actual real return of 5.82% over the past ten years, in a period when inflation was subdued at 2.68%.

The program allocation to regions and sectors will be specified in the annual plan for infrastructure. The regional allocations will include the U.S. and other developed markets (OECD) with a smaller allocation to emerging markets. Within the U.S., many projects could occur in California as the state has a $500 billion infrastructure requirement to meet the demands of a growing population over the next two decades. These projects will depend on the development and availability of investment structures, including PPPs. There are investment vehicles which focus on California initiatives within the existing funds. One of the funds that CalPERS has invested in (CIM) is focused on California investments and has made one investment in the Antelope Valley Water Bank for a total of $19.5 million.

The delegations for Staff to implement the Infrastructure Program inclusive of size limits will be submitted for Investment Committee approval after this policy is approved and prior to commencement of any investment activity.

Process

In the first quarter of 2007 CalPERS began to research infrastructure investment by developing an internal working group consisting of staff members from AIM, Fixed Income, Public Equities, Real Estate and Risk Management. With the formation of the ILAC in the fall of 2007 members of Asset Allocation/Risk Management, AIM and Real Estate staff members continued working with Pension Consulting Alliance (PCA) to further develop the infrastructure policy. Staff’s intention was to create a broad policy which would govern CalPERS’ overall infrastructure investment activity given that the infrastructure space is broad in terms of subsectors (energy, utilities, transportation, ports, water, communications, social infrastructure, etc.), deal types (private versus public assets that can be leased or sold), investment vehicles (funds, direct investments and co-investments) and geographies (domestic versus international investments).

In view of the public policy implications of infrastructure investments in the U.S., Staff has reached out to and been engaged in discussions with various constituent groups (including SEIU, LIUNA, AFSCME, PECG, California State Employees Association, Unite Here, California State Building and Construction Trade Council, and Ceres) in the development of the infrastructure policy since September 2007. Throughout the policy drafting period Staff has received ongoing comments and suggested changes from several of these entities In addition to individual conversations with interested parties, Staff organized group conference calls with labor constituents and PCA on November 2, 2007, January 31, 2008, February 22, 2008 and March 21, 2008. With each conference call the interested parties had an opportunity to submit oral and written comments regarding the proposed policy. CalPERS Chief Operating Investment Officer has also been engaged in the dialogue with interested parties. While various parties commented on multiple sections of the policy, the majority of the comments received from labor constituents focused on the Responsible Contractor Policy and Domestic Public Sector Jobs sections of the document. Attachment 3 outlines the comments received from various labor constituents.

In addition, Staff received comment from Ceres regarding the inclusion of language to address environmental issues. Ceres' letter is provided as Attachment 4.

Staff also provided investment management groups the opportunity to review the infrastructure policy. In November 2007 Staff asked the general partners of CalPERS' three existing infrastructure partnerships (Alinda, Carlyle Infrastructure Partners and CIM) to review the policy. In March 2008 Staff asked a wider group of infrastructure general partners including Babcock & Brown, JPMorgan, Goldman Sachs and Macquarie to comment on the policy. Overall general partners provided comments on areas of the document where they thought topics needed to be clarified or further discussed for applicability. A summary of the comments received from the general partners is in Attachment 5.

Description

As mentioned, the proposed infrastructure policy represents the culmination of intensive Staff consultation with consultants, labor representatives and investment managers. The policy provides Staff the flexibility to successfully implement the program, maintain CalPERS objectives and goals, and provide protections for the interest of public sector employees.

The Policy requires that an infrastructure strategy be established and revised over time, and that Staff develop an annual plan to be presented to the Committee for approval.

The Policy reflects the principles and application of CalPERS' Responsible Contractor and Public Outsourcing Policies as they relate to infrastructure investments. These policies provide protection for public sector employees and maintain CalPERS' support and encouragement of competitive bidding, fair wages and benefits for workers. The Policy also requires that any adverse effects of public-private partnerships on public sector employees be minimized.

The Policy also incorporates concepts related to environmental issues and practices.

Responsible Contractor Policy and Preference (Section VI.E.1)
The infrastructure policy utilizes CalPERS' Responsible Contractor Policy (RCP). The RCP applies particularly to real estate activities and investments. However, the RCP clearly defines principles of responsible contracting and outlines the processes related to the transition, enforcement, monitoring and administration of responsible contracting. While Staff considered the adoption of a separate infrastructure RCP, after careful review and consideration, Staff determined that the principles within the RCP are applicable to infrastructure activity and the current RCP should apply to infrastructure investment. As infrastructure investment moves forward under the new asset class, Staff will scrutinize the success of the policy and recommend revisions if appropriate.

Based on discussions with interested parties and upon Staff's understanding of the investment landscape, the proposed policy includes a section on responsible contracting applicable to domestic infrastructure investment vehicles. The basic elements set forth in more detail in the policy are:

- If the RCP would expressly apply, the manager must agree in writing to adhere to the RCP.

- If the RCP does not expressly apply (e.g. commingled funds, opportunity funds, mezzanine debt and hybrid debt), Staff shall give a strong preference to vehicles that adopt an internal policy on responsible contracting.

In addition, if the manager of any domestic infrastructure investment vehicle does not agree to comply with the CalPERS RCP or does not adopt an internal policy regarding responsible contracting and, if Staff considers the opportunity to be an attractive investment based on investment merits, Staff may recommend the potential investment to the Investment Committee and the Committee shall make a determination whether or not to invest in such investment vehicle.

Domestic Public Sector Jobs (Section VI.E.2)
The infrastructure policy reflects the principles of CalPERS' Domestic Public Outsourcing Policy. Staff has acknowledged the importance of public sector jobs. While recognizing that CalPERS may not have a controlling position in every transaction, Staff believes that CalPERS can encourage other parties to make a best faith effort to minimize public employee job loss. However, Staff also recognizes that job loss may occur even though every best faith effort is made to minimize employment reductions.

The infrastructure policy states that

> "…in circumstances where the investment vehicle is working with a state, local or municipal agency to establish PPPs or to bid on public offers for the sale, lease or management of public assets, the investment vehicle shall endeavor in good faith to recognize the important role and contribution of public employees to the development and operation of such assets. In particular, the investment vehicle shall make good faith efforts to ensure that such transactions minimize any potentially adverse impacts on employees. These efforts may include working directly with public employees, government officials, or collective bargaining groups, as appropriate, in order to take such reasonable actions as may be within the (investment vehicle's) control to mitigate such potentially adverse effects."

Compliance with this requirement shall be a key consideration by CalPERS when reviewing any future investment opportunities with an investment manager.

In addition, the proposed policy would require Staff to present to the Committee for consideration any investment that would directly impact the jobs of CalPERS' plan participants. Certain labor representatives have asserted that: this requirement should extend beyond CalPERS' plan participants to all CalPERS public sector jobs; and/or that there should be a complete prohibition on investments that would directly impact plan participants. If the Subcommittee wishes to incorporate these concepts, sections E(2) and (3) could be amended accordingly.

Interested parties were helpful in making recommendations to the policy and Staff implemented many of their suggestions throughout the policy. Many of the proposed language changes were included in the policy, particularly in the following sections:

> Section II G. Responsible stewardship through quality services, responsible labor and management practices and environmental factors.
>
> Section VI. Responsible Contractor Policy, Preference and Domestic Public Sector Jobs
>
> Section VI K 5. Labor Risk.
>
> Section VIII B 4 f. Review and analysis of ownership structure, employee benefit plans, anti-takeover provisions, labor contracts, and as appropriate consultation with labor representatives.

In addition, despite extensive discussions and good faith efforts, Staff and the various interested parties have been unable to reach resolution on all issues. In addition to the issues noted above regarding job impact, other outstanding issues and comments are reflected in the most recent (April) comments received by interested parties (see attachments 3 and 5).

The Policy states that the primary investment vehicles shall be partnerships/funds and direct investments, and specifies detailed investment guidelines for each in order to manage risks. These guidelines are similar to those contained in the CalPERS Alternative Investment Management (AIM) Program Policy approved by the Committee.

By reference to the Statement of Investment Policy for the Total Fund, the policy incorporates the fiduciary standard that investments be managed solely in the interest of the members of the system. This policy reflects the challenges of reconciling the public policy issues with the fiduciary standard but nonetheless seeks to achieve the strategic objectives set out in the policy including risk adjusted returns that meet benchmarks.

Opinion letters from PCA and Wilshire regarding this policy are included as Attachments 6 and 7.

V. STRATEGIC PLAN:

This item is consistent with Strategic Plan Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize contributions. This item is also consistent with Goal IX, achieve long-term, sustainable, risk-adjusted returns.

VI. RESULTS/COSTS:

As described in the September 2007 Investment Committee open session item 4c, the projected ILAC staffing and consulting costs are $1.8 million for 2007-08 and $1.7 million for 2008-09. These projections include the costs of hiring the Staff needed to manage the infrastructure and forestland programs and also assist existing Staff manage the commodities and inflation-linked bond programs.

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